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USAID/ECUADOR

ECUADOR CAPITAL MARKETS DEVELOPMENT

Final Report

March 10, 1993

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Price Waterhouse

March 10, 1993

Mr. Jim Watson
Agency for International Development
Avenida Colombia 1573 y Queseras del Medio
Quito, Ecuador

RE: AID/PRE/ - Financial Sector Development Project (FSDP)
Contract No. PDC-2206-Z-00-8191-00
USAID/Ecuador Capital Markets Development
PIO/T No. 518-0094-3-20097

Dear Jim:

We are pleased to present five English copies of the Final Report, Ecuador Capital Markets Development, prepared by Price Waterhouse. The Final Report incorporates the changes you have requested. These changes are being made to the Spanish version which will be sent shortly.

We have enjoyed the opportunity to assist USAID/Ecuador in this important assignment and look forward to further collaboration with the Mission.

Sincerely,

Barbara E. Friday

Barbara E. Friday, Deputy Director
Financial Sector Development Project

Enclosures

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LIST OF ACRONYMS AND ABBREVIATIONS

AAR	Asociación de Auto Regulación
AID	Agency for International Development
AY	Arthur Young
BID	Inter-American Development Bank
CFN	Corporación Financiera Nacional
CNV	Comisión Nacional de Valore
Corpec	Corporacion de Estudios Económicos y Consulteria Cia. Ltda.
FSDP	Price Waterhouse Financial Sector Development Project
GOE	Government of Ecuador
IESS	Ecuadorian Social Security Institute
IFC	International Finance Corporation
IMF	International Monetary Fund
MPAP	Macroeconomic Policy Analysis Project
NASD	National Association of Securities Dealers
OTC	Over the Counter Market
PW	Price Waterhouse
SRI	Stanford Research Institute
SRO	Self Regulatory Organization
T&I Project	Trade and Investment Project
U.S. SEC	U.S. Securities and Exchange Commission

I. EXECUTIVE SUMMARY

USAID/Ecuador is currently implementing a six year, $10 million Trade and Investment (T&I) Project to help increase Ecuador's reliance on market forces. In cooperation with a new organization, the Fundación Ecuador, the USAID is supporting capital market development. It is hoped that a more developed capital market will stimulate increased private investment and provide the financial resources to support an expanding private sector. Price Waterhouse, through the Financial Sector Development Project (FSDP), was contracted to prepare a strategic and action plan in support of capital market development for USAID/Ecuador.

Interest in and support for the development of Ecuador's financial sector, particularly its capital market, is not new. Several efforts beginning in 1984 analyzed the overall financial sector, assessed the macroeconomic environment and provided programmatic guidance to the USAID related to capital market development.

USAID/Quito began providing significant technical support to the process of financial sector reform in 1987 when Mr. Lewis Mendelson, an Attorney with the U.S. Securities and Exchange Commission (U.S. SEC), was contracted to work with a tri-partite commission on the development of Ecuador's capital market. In November 1988, Mendelson was invited back to Ecuador to review and make comments on a proposed securities markets law.

The 1988 draft, however, never became law. Between 1988 and 1992 the draft underwent several substantial revisions, and many of Mendelson's recommendations were incorporated therein. The new drafts defined the powers and responsibilities of the proposed regulatory agency, the Comisión Nacional de Valores (CNV), the stock exchanges, agents and all those participating in the market. The new drafts also increased protection to investors in public offers, described the distribution system, centralized the capital market in the two stock exchanges and also permitted an over-the-counter market.

With this background, in October 1992 the FSDP was contracted to develop a strategic plan and an action plan to support capital market development. Part of the scope of work was to examine factors which have constrained development of the capital market, specifically the formal exchanges. The team interviewed over 45 individuals in Quito and Guayaquil who cited the following reasons:

- companies would be willing to participate in the market if they had confidence in it and it provided added value
- companies are accustomed to using private sources of financing and have developed confidence in their banking arrangements
- legal restrictions imposed by the companies law and excessive bureaucracy significantly inhibit the ability to obtain long-term financing
- government participation in the exchanges has deterred participation of the private sector
- the restricted hours of exchange operation make it more advantageous to trade over-the-counter
- the exchange participants do not have a distribution network, whereas the banking system does

In order to address these and other constraints, the Price Waterhouse team has identified five specific strategic objectives for capital market development. The objectives and accompanying initiatives are:

Integrate the national securities market through mobilization of private sector initiatives and the completion of an inter-connected, automated trading system

- remove remaining restrictions on the participation of commercial banks in the securities market
- incorporate the two securities exchanges in the national market system
- establish an association to provide a self-regulatory structure for over the counter intermediaries not associated with either exchange
- establish a central depository and settlement system for listed securities
- reduce the direct participation of the government in securities markets operations

Mobilize medium- and long-term resources for investment through the securities market

- implement pension system reforms

- authorize the creation and public offer of indexed financial instruments
- reduce entry and exit barriers, and the discriminatory taxation of domestic and foreign portfolio investment capital
- facilitate the organization of mutual funds and other investment company products

Establish a clear, uniform and transparent regulatory framework for the securities market, with adequate institutional resources and authority for effective market supervision and enforcement

- establish an independent National Securities Commission
- revise companies laws and bank laws

Promote the development of a market "culture",attuned to securities market operations

Facilitate the development of market systems and institutions.

In order to carry out these initiatives, the team recommends a two-staged implementation plan. The most immediate effort is to form a leadership committee. Its role is to carry out efforts supportive of capital market development, with or without passage of the capital markets law.

The two main responsibilities of the committee are 1) to conduct analyses and policy dialogue and 2) to develop and carry out an action plan. Given the serious need for legislation, significant effort should be to support the passage of critical laws and regulations. Policy dialogue should consist of, but not be limited to the following activities:

- lobby for passage of the Capital Markets Law
- design changes to and lobby for passage of modifications to the Companies Law
- lobby for pension system reform
- determine obstacles to foreign investment
- introduce additional investment vehicles

- assure freedom of entry into the market

Through USAID/Quito and the Fundación Ecuador, short-term consultants should be contracted in order to make recommendations for policy dialogue, lend discipline to the process and perform research, as needed.

Concurrent to policy dialogue efforts, the leadership committee should develop a plan to accomplish the objectives set forth above and to build consensus for the plan. An illustrative set of initiatives is outlined below and is organized according the strategic objectives listed earlier.

Objective: Integrate the market
Initiative: Develop a computerized, national market system and a central depository system

For this effort, technical assistance should be provided to:

- analyze legal and market impediments if a computerized market is developed without passage of the Capital Markets Law
- develop an organizational structure and business plan, including cost projections
- design technical specifications
- analyze systems requirements and cost
- install system

Training should be provided in the operation of the system and short-term overseas placement with the National Association of Securities Dealers (NASD) or with NASD members should be considered. Complementing these efforts should be a communications effort focussed on market intermediaries, the private productive sectors and the public. Seminars and a publicity campaign to promote awareness of the system should be considered.

Objective: Mobilize medium- and long-term resources
Initiative: Reform the pension system

Technical assistance in the following areas should be provided:

- analyze alternatives for reform, ranging from improved investment policies and practices to privatization of social security retirement fund management

- assist in the establishment of investment policies and prudential investment rules for pension funds

- analyze alternate means for monetary management by the Central Bank that do not restrict discretionary powers of pension fund managers

- assist in establishing the regulatory framework for operation of pension management system

Portfolio management training for pension fund managers and training in pension fund supervision and regulation for the regulatory authority should be considered. A communications effort should be undertaken to explain changes in the pension system. This should include a public information campaign as well as seminars for public and private sector managers to explain the operations of the new system.

Objective: Establish a regulatory framework
Initiative: Develop a self-regulatory organization and a regulatory agency the Comisión Nacional de Valores (CNV)

Regulatory experts (short or long-term) with NASD/SEC experience can work with the CNV, the banks and the exchanges to:

- develop Self Regulatory Organization (SRO) rules; develop consensus for method of operation of the SRO

- develop CNV division functions; develop a one-year and a five-year plan for each division; assist in the rule writing process

- develop a comprehensive surveillance and enforcement program, including SRO and CNV

- at a later stage, consider development of the accounting profession, emphasizing enforcement

In-country, one-on-one training with each division chief of the CNV should be considered as well as overseas training tours, including internships with the SEC and NASD.

Objective: Promote a market "culture"

The USAID and Fundación Ecuador should provide technical assistance to develop a training and communications program to build awareness of the capital market. Training for market intermediaries, accountants and regulators should be considered as well as a communications program through public media and seminars.

Objective: Develop Market Institutions

Experts in portfolio investment, new financial instruments, brokerage services, venture capital funds and mutual funds should be provided. Outside experts could also work with the Ecuadorian private sector to devise methods of encouraging joint ventures with foreign investment banks. Seminars should be organized for financial intermediaries in topics such as retail marketing, structuring of investment alternatives, underwriting, investment club formations, brokerage firm operations, mortgage-backed securities, mutual funds, securities market operations, portfolio investment, or venture capital.

II. BACKGROUND

A. USAID/Ecuador Trade and Investment Program

USAID/Ecuador is currently implementing a six year, $10 million Trade and Investment (T&I) Project to help increase Ecuador's reliance on market factors such as export-oriented growth, privatization and capital market development. The project goal is to support achievement of broad-based, sustainable economic development. The purpose is to provide quality export and investment services and support the institutional development of a viable Ecuadorian trade and investment organization. Capital market development has been identified as one of the key means of attaining these goals.

A new organization, Fundación Ecuador, was founded in 1992. Working through a Cooperative Agreement with the USAID, it is anticipated that the Fundación will assume responsibility for the T&I Project through the promotion of trade and investment. Among its primary activities will be support of privatization and capital market development. It is hoped that a more developed capital market will stimulate increased private investment and provide the financial resources to support an expanding private sector.

One of the key objectives of the T&I Project is improvement in the trade and investment climate which will result in increased domestic and foreign investment in Ecuador. Both are considered important elements to the implementation of privatization and the deepening of the capital market.

B. Objective of this Assignment and Scope of Work

Key components of Fundación Ecuador's assistance to the newly inaugurated government (August 1992) are privatization and capital market development. The purpose of this assignment was to prepare a strategic and action plan for the USAID, Fundación Ecuador, and the Stock Exchanges of Quito and Guayaquil in support of capital market development. Specifically, the scope was to:

- review and assess prior technical and financial assistance to the Ecuadorian financial sector during the period 1985 to 1992;
- prepare a strategic plan for the development of the Ecuadorian capital market including the role, actions and activities which should be undertaken by the principal implementing agencies and/or participants in

supporting capital market development: Fundación Ecuador, USAID/Ecuador and the Stock Excanges of Quito and Guayaquil;

- prepare and implement a questionnaire/ survey for the detailed interview of 20-25 companies and related institutions that are currently using or expect to use the Ecuadorian stock exchanges as important means of equity and debt financing;

- provide USAID/Ecuador, Fundación Ecuador, and the Stock Exchanges of Quito and Guayaquil with recommendations regarding next steps including the appropriateness and potential effectiveness of several possible initiatives for the coming year;

- prepare and submit the resulting report in both English and Spanish.

C. Team Composition and Timing

A three person team was contracted to carry out this assignment, and their field work took place October 5-16, 1992. The members were:

- Barbara Friday, Team Leader and Deputy Director of the Price Waterhouse Financial Sector Development Project;

- Jan Aalbregste, Regulatory Analyst and Senior Manager, Price Waterhouse;

- Philip Rourk, Capital Market Specialist and President of A.G. International, subcontractor for this assignment.

D. Methodology and Organization of Report

The methodology for this assignment included a combination of background research and meetings with representatives from the public and private sectors.

The team consulted over 45 documents in the preparation of this report. Major findings from those most relevant form the basis of Chapter III, Setting, and a complete listing can be found in Appendix A.

Interviews were conducted with more than 40 individuals in Ecuador and in the United States. The team interviewed private sector individuals from both Quito and Guayaquil representing a broad cross section of the private productive sector, private financial sector, accounting profession, brokers and the stock exchanges. Meeting were held with public sector representatives from the Ecuadorian Central Bank, National Development Bank, National Finance Corporation and the Superintendency of Companies as well as from USAID/Quito and the U.S. SEC.

The format included informal give and take, the posing of structured questions, an exchange of ideas based on a written presentation of the team's preliminary findings and recommendations and finally, the team's formal presentation to the USAID.

The results of the team's questionnaire are found in Section IV. Findings.

The team's overall conclusions are presented in the final two sections of this report including V. Diagnostic and Strategic Approach and VI. Implementation Plan.

III. SETTING

One of the requirements of the Scope of Work for this engagement was to conduct a desk review of reports prepared for USAID and other donors since 1985. A complete listing of documents consulted appears in Appendix A, and the findings and recommendations of the 12 most significant are summarized below.

Interest in and support for the development of Ecuador's financial sector, particularly its capital market, is not new. Several efforts beginning in 1984 analyzed the overall financial sector, assessed the macroeconomic environment and provided programmatic guidance to the USAID. These reports are summarized in the first part of this section.

Since 1988 both the USAID and the British Overseas Development Administration have focussed particular attention on development of the securities market. The second part of this section reviews analyses and reports related to securities market development.

A. Financial Sector and Macroeconomic Studies

1. <u>Report on Economic Advisory Services to USAID/Ecuador</u> Price Waterhouse, August 1984 by Len Horwitz, Sidney Weintraub

In 1984, just as the Febres Cordero administration was assuming office, Price Waterhouse (PW) conducted a comprehensive review and assessment of Ecuador's economic sectors. The purpose of this study was to develop a program of economic policy research, studies and technical assistance to be carried out by USAID and other donors. Many of the recommendations made in the PW report were implemented or followed up on in subsequent years.

Among the most important realities that the Febres Cordero administration had to address were the effects of prior policies which had distorted the economy during the years of petroleum-induced high economic growth. Dependence on petroleum had become both a blessing and a curse; the benefits of economic growth were tempered by unwise policy choices whose consequences were beginning to become apparent in the early eighties. These policies were often nationalistic and relied too heavily on one export, petroleum. Additionally, as with many other countries in Latin America, the Government of Ecuador (GOE) had followed an import substitution model, imposed price controls and had neglected traditional agriculture. Nationalism resulted in many foreign firms leaving Ecuador. which led to a consequent decline in new petroleum exploration. Stagnant production followed by declining oil prices contributed significantly to the country's economic downturn. Earlier policies which had been designed to help the consumer, such as price controls on basic commodities, subsidized petroleum prices, and interest rate and exchange rate controls, had very negative consequences later on.

The incoming government aimed to address these problems by relying more heavily on market forces and altering or eliminating many measures that distorted price relationships. Some of its policies were to accelerate unification of the multiple exchange rate, achieve positive interest rates in real terms, increase petroleum and electricity prices, promote low-income housing, and increase public wages. The government began negotiations with the IMF and with private creditors for more generous rescheduling of Ecuador's external debt.

The authors of the 1984 study supported the overall direction of the new government's policies and recommended a series of program options for the donor community to consider to help the GOE attain its goals. In the early 1980s the Inter-American Development Bank was Ecuador's largest donor, and at the end of 1983 was funding 26 projects, primarily in the areas of infrastructure development, energy, sewage, irrigation, agriculture and industrial credit. At the same time, the World Bank was financing 17 projects in Ecuador while the International Finance Corporation (IFC) supported seven.

The modest USAID program supported agriculture, rural development, nutrition, population, health and education projects. There was little emphasis on private sector or financial sector development save for projects focused on small and medium sized enterprises and export and investment promotion.

The PW report proposed a wide range of programs to support a variety of sectors including: fiscal, monetary/capital market, agriculture, forestry, housing, social security, human resource development, industry and private sector development, commercial and investment policy, petroleum, mining, electricity, employment generation, and natural resource planning/management.

With regard to the Capital Market, the team recommended that a fifteen person month ($270,000) Capital Market Development Study be undertaken, to be financed by either AID or the Inter-American Development Bank (BID).

The PW team recommended that the study assess the policy, program and institutional factors associated with capital market development. It should examine:

- key factors governing the mobilization of domestic savings: interest rates, exchange rates and credit policies; how to move to positive interest rates;

- policy and institutional needs to develop an active capital market: strengthening financial intermediaries, banks, financieras, insurance companies, the stock exchanges, bond market, etc.;

- institutional analysis of public sector banking and regulatory institutions: their relationships with private banks and financieras, current problems of private banks, role and functioning of Superintendency of Banks vis-à-vis private banks, review of the Central Bank's ability to manage the external debt.

The team noted the negative interest rate structure was a disincentive to save. Negative interest rates also meant that the commercial banks, due to their inability to mobilize sufficient resources on their own, had become agents of the Central Bank. This situation compounded a growing reliance on foreign credit sources and an increase in the foreign debt. As the report was written, many banks and private companies were in deep financial trouble; they had overlent and overborrowed far too heavily.

The team recommended that the upcoming study analyze alternative means for using social security resources in the development of the capital market. It recommended a gradual reorientation of social security investments into productive activities, preferably in the private sector. The team explained that the IESS continued to be the main, and at times the sole purchaser of treasury bonds and long-term mortgage bonds. The IESS was the main supplier of credit to the financial system, exceeding even the Central Bank.

With these recommendations USAID contracted several subsequent financial and capital market analyses, which are discussed below. The first of these took place five months after the PW study, in February 1985, and was conducted by Arthur Young.

2. <u>Financial Markets Assessment Report Ecuador</u>. Arthur Young, February 14, 1985 by John Vanderveen

While the PW report offered policy and program recommendations for a variety of sectors, the Arthur Young (AY) study focused exclusively on the financial sector. It reflected the USAID Mission's focus on identifying and diagnosing the policy, regulatory and legal constraints which impeded the mobilization of domestic savings and the development of a capital market.

The author noted that, in its first five months in office, the GOE under Febres Cordero had indicated a solid commitment to private sector development and placed a high priority on financial market structural reform. He cited some of the efforts undertaken by the Febres Cordero administration which included beginning a "sucretization" process, converting foreign debt to local currency; moving from a three tiered exchange rate to two; lowering subsidies; successfully introducing short-term debt instruments; and presenting to Congress laws and regulations which could be favorable to capital market development.

The author noted, however, that the scope of future reform was considerable. The banks and finance companies were weak, the unregulated over-the-counter market was large and the stock exchanges were, for the most part, irrelevant.

At the time the report was written (1985) there were thirty-one commercial banks, twelve financieras, eight savings and loans, and twenty-seven insurance companies. The banks were overly fragmented, not competitive, under-capitalized, over-extended and generally weak.

Expanding upon the earlier PW findings, the AY report explains that during the 1980-1984 time frame, savings deposits fell, demand deposits remained stagnant and commercial banks and financieras relied increasingly on credit from the Central Bank as their single major source of domestic credit. This reliance on the Central Bank rediscount window meant that a significant portion of loanable funds were "directed" to either particular investments in certain areas or to the purchases of government bonds.

In 1985, activity on the two stock exchanges was confined to trading private sector mortgage notes issued by commercial banks and financieras, or to trading certain GOE issued paper such as monetary stabilization bonds. The reasons cited for the lack of equity trading included: no mass market, no tradition of stock trading, an absence of laws concerning disclosure, and taxes on dividends which were high relative to other taxes. **Many of these reasons remain valid in 1992.**

Also similar to today's capital market reality, in 1985 there was a flourishing illegal "mercado extra-bancario". In 1984 approximately $30 billion moved through this market--about 3.8% of GDP or 10% of combined assets of private sector banks.

The AY study cited a World Bank report which had recently concluded that capital market development was inhibited by laws and regulations. The Bank recommended that a highly qualified team be put in place to assist the GOE in drafting laws regarding the regulation of corporate disclosure, auditing standards, underwriting, and associated matters. Subsequent USAID support has addressed this recommendation, and is discussed in the latter part of this section.

The AY report strongly endorsed that AID actively pursue financial markets development. At the time of the author's visit, the Mission was in the process of finalizing the Macroeconomic Policy Analysis Project (MPAP). The objective of MPAP was first to analyze the major impediments to the mobilization of domestic savings and the development of a domestic capital market, and second, to design a plan to implement the necessary policy reforms required through two Mission programs: a) a three year capital markets development project and b) a two year fiscal administration project.

3. Ecuador Macroeconomic Policy Analysis Project: Capital Markets Report SRI, July 1986

The analysis of the capital market carried out under MPAP was performed the following year in July, 1986 by the Stanford Research Institute (SRI). This highly technical report offers a comprehensive economic analysis of the factors inhibiting the development of a capital market in Ecuador. It discusses interest rates, savings and credit; debt and equity markets and their regulation; funding and supervision of financial institutions; government credit programs and subsidy analysis, and the role of foreign technical assistance.

Among the disincentives to capital market development were availability of low cost government funded or controlled credit at negative real rates of interest; a tax policy which strongly favored debt over equity; government policies prohibiting companies from issuing debt at rates above the maximum bank lending rate; requirements that all corporate debt be backed by real property; red tape, and lack of disclosure.

Among the report's conclusions, one which remains valid in 1992, is the need to reform the social security system. The authors suggested providing more flexibility to the Ecuadorian Social Security Institute (IESS) in making investments in private corporate debt and equity. This, in turn, could provide substantial funds in support of an expanded private capital market. Consideration of the sale of IESS assets such as the Hotel Quito building was regarded as an important government initiative in the general area of sale of government shares in private sector enterprises.

4. <u>Capital Markets Assessment and Follow-up</u> July 1987, by Corpec (Corporacion de Estudios Economicos y Consulteria Cia. Ltda.)

A year later, in July 1987, Corpec summarized the analyses offered in the SRI report and updated the progress made during the first three years of the Febres Cordero administration. It outlined the downturn in the economy between 1985 and 1987. The authors explained that, among other factors, the March 5, 1987 earthquake had severely affected the economy by severing oil production. This event and its impact is discussed in greater detail in the World Bank's 1991 report.

5. <u>Ecuador: Public Sector Reforms for Growth in the Era of Declining Oil Output</u> The World Bank, 1991

The 1987 earthquake had a devastating effect on the economy, as it destroyed Ecuador's only pipeline and interrupted oil exports for three months. Declining oil production and prices, combined with severe rains and flooding, put the economy in decline. Additionally, inflation, which had decreased between 1983 and 1986 from 39% to 21%, rose dramatically in 1988 to 86%. The deterioration of the economy peaked between late 1987 and the first semester of 1988.

When the Borja government took office in August 1988 it began to implement a strong adjustment program combining fiscal and monetary measures with control of exchange rate transactions. Domestic petroleum prices were increased almost one hundred percent, the sucre was devalued by 42 percent, some fiscal expenditures were reduced and some tariffs and indirect tax rates were raised. The reform made it possible to contain the fiscal deficit and allow monetary authorities to bring monetary policy in line with stabilization efforts.

6. <u>Ecuador's Financial System and Macroeconomic Policy: Implications for Stabilization and Growth</u> Sigma One Corporation, February 1991.

Inflation became a terrible, and remains a persistent and growing problem. As explained in detail in the Sigma One report, prepared in February 1991, "an important feature of Ecuador's economic landscape throughout much of the 1980s has been a prolonged and growing inflation." In fact, the primary finding of this report is that high inflation has been the most important problem facing Ecuador's economy and confronting its policy makers. The authors' premise is that until inflation is reduced to a tolerable level, efforts to restructure the economy and achieve growth will fail. They identify the key to winning the battle against inflation to be continuation of and increased attention to the process of financial sector reform.

B. Securities Market Reports

USAID/Quito began providing significant technical support to the process of financial sector reform in 1987 when Mr. Lewis Mendelson, an Attorney at the U.S. Securities and Exchange Commission (SEC), was contracted to work with a tri-partite commission on the development of Ecuador's capital market. Mr. Mendelson has provided on-going assistance to the process since then. His efforts have been complemented by Mr. Jonathan Miller, who was contracted by the U.K. Overseas Development Administration to report on the requirements for establishing a capital market. This section summarizes the securities markets reports prepared by Mendelson and Miller.

1. <u>Report of the Tri-partite Commission</u> by Lewis Mendelson, for USAID, October 15, 1987

In 1987, a Tri-partite Commission was created and its efforts were supported by USAID through the provision of the technical advisory services of Mr. Lewis Mendelson of the SEC. The Commission consisted of representatives from the stock exchanges of Quito and Guayaquil, the Associations of Agents from the two exchanges, and the Superintendency of Companies.

The objective of the Commission was to strengthen the national securities market through:

- integrating, increasing and stimulating the securities markets;
- integrating the exchanges to achieve a national market;
- implementing a universal regulatory framework;
- providing investment opportunities for small savers;
- supporting a strong secondary market, and
- widening the range of financial instruments available.

Obstacles to the development of the market were identified to be the tax system, negative interest rates, tradition, privacy, lack of disclosure, the closed nature of business transactions, poor accounting norms, and partial control over the Securities Market.

The Commission recommended a three phased implementation plan which entailed:

a. Strengthening personnel and facilities of the Securities Department of the Superintendency of Companies;

   Initiating structural and functional changes in the exchanges of Quito and Guayaquil, especially by the CFN selling its shares on the two exchanges and the transferring of ownership of the exchanges to the agents;

   Drafting new rules and regulations for the Superintendency of Companies;

   Implementing training programs;

   Preparing draft legislation for the new Congress on both technical and policy levels.

b. Enlisting the participation and cooperation of the Superintendency of Banks in preparing and adopting a regulatory system to control the market outside the exchanges, involving banking and financial institutions under its control;

c. Adopting a new securities law to create an SEC-type institution, CNV, to transform the exchanges into non-profit organizations and to permit the formation of self-regulatory organizations under the control of the CNV.

The report notes that operations on the exchanges declined significantly between 1985 and 1987. One reason for that decline, which remains a significant factor today, was the considerable increase in volume of activity carried out by the banks and financieras outside the exchanges.

The report explains that the market for trading shares on the exchanges was practically nil and highly concentrated, attributable largely to the closed nature and family structure of most businesses. In 1986 only 39 companies were listed on the exchanges of which there were 22 businesses, 10 banks, 6 finance companies and one warehousing operation. Of these, only 18 traded shares on the exchange. Due to the closed nature of business, as well as other factors, there was a scarcity of shares to trade.

2. Comments on Proposed Stock Market Law by Lewis Mendelson, for USAID, November 19, 1988.

In November 1988, Mendelson was invited back to Ecuador to review and make comments on a proposed securities markets law. As he states in the opening of his report, the fact that the draft law existed represented a significant step forward.

The draft law of 1988 proposed five major ways to improve the existing regulatory system:

- introduce a comprehensive regulatory structure through creation of the CNV;
- permit public offers of securities;
- provide tax incentives;
- create a more centralized market, and
- strengthen investor protection.

Mendelson viewed the proposed law as an enabling statute whose success would depend greatly on the individuals charged with its implementation. He recommended that the law be changed in four basic respects including:

- Strengthening the structure of the CNV. He viewed the structure as proposed as unworkable and recommended a small, high level, independent and fully dedicated working body;
- Transferring ownership of the exchanges from the government and/or other private sector interest to their members. This would enhance the institutions' self-regulatory capabilities;
- Easing the restrictions on ownership of seats on the exchanges;
- Encouraging and authorizing the regulation of investment companies.

The 1988 draft never became law. Between 1988 and 1992 the draft underwent several substantial revisions, and many of Mendelson's earlier recommendations have been incorporated. Some of these revisions are discussed below.

3. **Report of the Proposed Capital Market Law by Lewis Mendelson, for USAID, March 13, 1992**

4. **Informe Preliminar Sobre los Borradores de la Ley de Mercado de Valores, Fechados 1 de abril y 20 de abril de 1992, by Lewis Mendelson, for USAID, June 1, 1992**

In the spring of 1992, Mendelson prepared two reports on three drafts of the securities market law. Onc report was prepared in March and a later, more detailed report was prepared in June.

Mendelson found the revised drafts to be much improved from earlier versions, providing what he considered to be an excellent structure for the regulation and development of the capital market through the CNV. Both of his reports offer a point by point analysis of the draft laws focussing mainly on the regulatory structure, public offers and intermediaries.

Following on Mendelson's earlier advice, the new drafts carefully defined the powers and responsibilities of the CNV, stock exchanges, agents and all those participating in the market. He considered one of the most important changes to be the incorporation of his suggestion for an autonomous, Presidentially-appointed commission with centralized authority. Such an approach would help address the detrimental affects of Ecuador's fragmented regulatory structure in which the same regulations have not, and do not, apply to all participants in the market.

Other provisions of the new drafts enhanced the investigative authority of the CNV, created additional registries for auditors and risk assessors, contemplated a regulated over-the-counter market and included clearer definitions regarding prohibitions on the use of privileged information.

The new drafts also increased protection to investors in public offers and described the distribution system. The revised drafts would centralize the capital market in the two stock exchanges and also permit an over-the-counter market. They specified that securities listed on the stock exchanges could not be traded in the OTC market, which would be regulated in a manner parallel to the stock exchanges.

5. Report on Setting Up a Capital Market by Jonathan Miller, for the U.K. Overseas Development Administration, June 1992

In June of 1992, Mr. Jonathan Miller prepared "Report on Setting Up a Capital Market." In it, Miller analyzes the objectives and provisions of the draft capital markets law, dated April 20, 1992. He discusses the technical needs of the GOE as well as the resources available to meet them.

As of June 1992, the declared objectives as expressed in the draft law were:

- to provide the means of financing Ecuadorian companies out of domestic savings;
- to extend securities market regulation beyond the exchanges to the over-the-counter market;
- to protect the interests of investors;
- to widen share ownership, and
- to improve and modernize the legal and institutional framework for the securities market.

As he discusses, the draft securities market law has been in preparation for ten years. He concurs with Mendelson's assessment that the April 1992 draft law is much improved from earlier versions. He cautions, however, that proposed sanctions were weak, and the staffing and funding provisions seemed insufficient, as did those for the control of investment advisors.

Miller notes that the greatest difficulty will be in transforming the stock exchanges into non-profit companies. He observes that this requires 100% acceptance by the shareholders and is not feasible. He further explains that the Guayaquil Exchange is currently 70% owned by the CFN, 20% by the agents and "casas de bolsa" and 10% by external shareholders. The Quito Exchange has 382 shareholders, of which the CFN is the largest with 34% of the capital.[1] Miller notes that the importance of the transformation of the exchanges to non-profit entities relates to overcoming the potential for conflict of interest problems, but is not an issue which must be addressed

[1]It is important to note that at the time of the FSDP consultancy (October 1992) the CFN was selling its shares in both exchanges to the private sector.

immediately. He also offers a possible solution and outlines procedures to effect such a transformation.

He recommends that the new government implement a Capital Market Development Program with clear policy goals and steps to meet them. The new government should focus attention on:

- completing legislative measures necessary to the operation of the capital market;
- creating the needed regulatory organizations;
- issuing regulations;
- developing the skills and facilities for managing primary issues by the government;
- implementing a program of public relations, technical assistance, and training to prepare issuers to raise money by public offers of securities;
- preparing the public for participation in the market, and
- reviewing and revising the legal, fiscal, institutional and regulatory framework.

6. Draft Strategic Plan for the Implementation of Ecuador's Securities Market Law, by Lewis Mendelson, for USAID, August 1, 1992.

Complementing his earlier work as well as that of Jonathan Miller, Lewis Mendelson submitted a draft "Strategic Plan for the Implementation of Ecuador's Securities Market Law" on August 1, 1992. This report provides Ecuadorian policy makers with a practical guide to implementing the provisions of the law. It discusses the leadership needed to plan for the CNV; funding, staffing and training for the CNV; and critical decisions involving the exchanges, banks and privatization, all of which will effect how the CNV will function. Mendelson's report assumes that the draft law he reviewed for the consultancy would soon be passed and with few changes.

The importance of leadership was stressed again by Mendelson who suggested that the first step would be the designation of a President of the CNV. A second issue of major importance is that of funding and assuring that the CNV has sufficient resources for its early years of operations. Funding sources coulo include the government, the private sector and the international donor agencies.

Mendelson outlines several key decisions that need to be addressed in the near future including transforming the exchanges into not-for-profit corporations, establishing exchange clearing and registry facilities, defining the role of the banks, and defining the role of the CNV in development and privatization.

Finally, he discusses priority issues on which to focus in order to phase in regulation. He looks at both the transitional phase (budgetary support, drafting rules and regulations), and at the organization of the CNV (administration, departments for disclosure and review, market oversight and regulation, investment advisers and investment companies, enforcement and the General Counsel).

With this background, the PW Financial Sector Development Project (FSDP) was contracted to develop a strategic plan and an action plan to support capital market development. Since much of the earlier efforts had focused primarily on the regulatory framework, this team focused on confirming earlier findings and also examining other issues which have constrained development of the capital market. The next section of this report examines factors inhibiting private sector participation in the stock exchanges.

IV. FINDINGS

A. Objectives of the Interviews

As noted in the previous chapter, capital market development in Ecuador has been the focus of considerable attention over the past eight years. One finding that is discussed in several earlier reports and remains valid, if not of greater significance today, is that most capital market activity takes place outside the exchanges and is unregulated. In order to better understand why this is so, the team met with approximately fifty individuals from the private and public sectors. With a special focus on private entrepreneurs and businessmen, the team sought to answer the following basic questions:

- Why don't companies use the bolsa?
- Where do they presently obtain capital?
- Is there a need for a capital market?
- If so, what are the principal obstacles to its development?

A more complete list of questions and summarized responses follow.

B. Questions Posed and Findings

1. Why don't companies use the bolsa?

The main reason why companies do not use the exchanges is that they do not perceive there to be any added value gained through the exchanges. In addition, companies are accustomed to using private sources of financing and have developed confidence in their banking arrangements. While these attitudes are not easy to change, it is felt that the culture can be changed slowly.

Several deterrents were mentioned and include:

> Commissions. The commission charged for exchange transactions was viewed as a deterrent, primarily because companies did not view the exchanges as providing added value that justified a commission.

Delays. Bureaucracy and delays were cited as major obstacles to raising capital in public markets. The delays appear to result from an outdated companies law. The fact that the exchanges are open for only limited hours each day was also cited as a problem for financial intermediaries.

Inability of markets to place securities. The private sector displayed a lack of confidence in the exchanges and the absence of a developed distribution network. Distribution networks have been established through banks and private sources; companies have confidence in these sectors.

Lack of regulation of the over-the-counter market. The "uneven playing field" was cited by many market participants as a reason for the lack of a cohesive, centralized market. Fear of government knowledge of a company's affairs and government involvement in the market were also noted.

Settlement delays. At present, the market is not sufficiently developed for there to be significant delays. However, the present legal structure governing settlement would cause substantial problems if the market were to grow.

Disclosure obligations. Companies stated that they prefer not to disclose their results of operations. However, many also noted that the companies law already requires disclosure, and indicated that disclosure would not be a barrier if the market added value. Taxes do not appear to constitute a major barrier to capital market participation because of the low rates that are presently applicable.

Lack of a need for capital. While there is not a great need for capital for expansion at the present time, companies need long-term financing to replace their short-term obligations.

2. Where do companies presently obtain capital? Is long-term capital available?

Most companies obtain short-term financing through banking arrangements and private sources. Very little long-term capital is available.

3. Is there need for a capital market?

Most companies support the development of a capital market, recognizing its utility in providing long-term financing and developing the country. The majority of the private sector indicated a willingness to participate in development of a capital market. Some skepticism was voiced, however, about the ability of the private sector to reach a consensus on the method of developing the market.

4. What are the principal obstacles to development of the capital market?

There was no consensus regarding the principle obstacle. The most consistent themes were the banking culture and the bureaucracy.

5. If the market were developed and provided added value, would companies raise capital in the market? Is fear of loss of control an issue?

Companies would be willing to participate in the market if they had confidence in it and it provided added value. Fear of loss of control is not an issue because companies can choose to maintain majority ownership while selling a minority interest to raise capital through the market.

6. Do companies trust the exchanges? If a confidence problem exists, why and how can it be changed?

Confidence has not been developed in exchange participants, whereas people trust their bankers. This could change slowly if the exchanges are viewed as providing added value and as familiarity with the exchanges is increased. The best method of achieving this goal is to have the banks participate in the exchanges.

7. Does government participation in the market inhibit participation?

Government participation in the exchanges has deterred the private sector from taking part, primarily due to a general distrust of systems run and controlled by the government.

8. Is there a problem with understanding the market and opportunities for raising capital publicly?

A consistent theme that arose in our meetings was the focus of Ecuadorian culture on bank financing and the use of banks as intermediaries. This is due in part to a lack of alternatives for long-term investment, and also to a lack of familiarity with the market. Private companies understand the need for long-term financing, but while they may need assistance in structuring public offerings, lack of understanding of capital markets does not seem to be a major obstacle to their participation.

9. Are there sufficient resources for investment in the exchanges? What sources exist?

Significant resources exist in Ecuador. Most are presently invested through banks. In addition, there is a significant quantity of flight capital. Some of these resources can be redirected through a long-term capital market if appropriate macroeconomic and legal policy is adopted. There is a general view, however, that institutional sources, such as pension funds and mutual funds, are required to develop the market significantly.

10. What problems exist with present laws regulating capital formation?

The principal problems with the present legal structure are the lack of an even playing field due to failure to regulate the over-the-counter market, and antiquated companies law provisions that delay offerings and regulate the types of instruments which can be created. Policies that prohibit indexation and restrict foreign investment also contribute to the problem. These problems with the legal system significantly inhibit participation in the market.

11. What types of securities are sold outside of the exchanges? What is the size of the over-the-counter market?

No statistics exist regarding the size of the over-the-counter market; this market is reported to be at least 10-20 times the size of the exchange market. The Over the Counter (OTC) market is comprised primarily of short-term private debt instruments.

V. ASSESSMENT AND STRATEGIC APPROACH

A. Introduction

This section of the Price Waterhouse FSDP report draws upon lessons from prior studies, incorporates current findings and presents the team's analysis of the constraints and opportunities facing the Ecuadorian capital market. It then proposes a strategic approach for capital market development.

The chapter is divided into two main parts. The first part provides a conceptual framework for the later discussion of programmatic support to capital market development. It defines what financial markets are and what they are designed to do; it summarizes current market conditions in Ecuador, including the current policy framework and proposed legislation.

The second part of the chapter recommends five strategic objectives as well as the initiatives needed to achieve them. Those five objectives are to: integrate the national securities market; mobilize medium- and long-term investment resources; establish a transparent regulatory framework; promote a market "culture"; and develop market systems and institutions.

B. Financial Markets

Financial markets are subdivided, somewhat arbitrarily with respect to the exact lines of demarcation, into two major segments: the bank credit market and the securities market. The securities market, in turn, is further subdivided by the term of securities traded into the short-term "money" market, and the medium- and long-term "capital" market. The capital market is itself composed of two main segments according to the nature of obligations traded, i.e. the "debt" and the "equities" markets.

While they remain useful for analytical and reporting purposes, product innovation in each of these segments has led to a blurring of some of these distinctions, and to increasing overlap in the functions of specialized market institutions operating in them. Thus, banks in many parts of the world are increasingly involved in the generation and direct placement of money market "securities" such as certificates of deposit and a variety of index-based derivative instruments, while some medium- and long-term debt issues have been developed to offer equity features to investors, and vice versa.

What remains true is the essential interconnectedness and interdependence of all parts of a financial market. Developments in one segment will inescapably affect other parts of the market, hopefully in a positive manner through increased product specialization, competition and efficiency. Also, the functions of a financial market and its various components remain essentially linked to the nature and characteristics of the productive economy, and its development must follow the specific opportunities and needs that are present at any given time in each country. International experience is a valuable guide, but there is no universal prescription for capital market development that is independent of the specific structure and characteristics of the general economy, nor of the specific structure of other elements of the financial market that are encountered in each country.

C. Desirable Features of a Capital Market

From an economic development perspective, the following are the main features the capital market is expected to exhibit:

- The ability to mobilize private domestic and external savings in volumes that can make a significant contribution to financing investment;
- The ability to allocate savings efficiently to their highest-value use in investment;
- The ability to contribute to the overall efficiency of the financial system;
- Transparency and efficiency in operations, with security and protection from potential abuses against either issuers or investors.

D. Summary of Ecuadorian Market Conditions

The key economic and financial market characteristics described in this section guide the development of an appropriate capital market development strategy in Ecuador.

First, it should be understood that the economy is dominated by a government-controlled petroleum sector, followed in importance by a small number of agricultural and fisheries exports such as shrimp, bananas, cocoa and coffee. Manufacturing is normally small-scale, and largely focused on the needs of the domestic market such as beverages, pharmaceuticals, textiles and the assembly of household appliances. A relatively small number of closely-held companies dominate production in each of these key sectors. The reluctance of such companies to accept full disclosure of financial information to the public, or to broaden participation in share ownership, have been traditional impediments to the development of private sector issues for placement in the domestic securities market. The government, through the Ministry of Finance, the Central Bank and a small number of development finance institutions has therefore been the principal source of medium and long-term securities available in the market. The government, of course, issues debt instruments rather than equity.

On the demand side, low average incomes and a highly skewed income distribution severely limit the current size of the market. A small number of wealthy individuals, and the corporate treasuries of an equally small number of companies divide their investments between short- and long-term Ecuadorian securities and the myriad offerings available to them offshore. A small number of domestic life insurance companies reinsures heavily abroad, while only a small number of independent pension funds exists, and no organized mutual funds are to be found. Investable savings in the economy are strongly concentrated in the Ecuadorian Social Security Institute (IESS), which is, in fact, the major purchaser of medium- and long-term (government) securities issues.

Commercial banks are also significant investors in government securities, and are by far the major force in the country's financial markets. In addition to straight commercial credit, many of the country's 30-odd banks have established credit card operations, leasing, factoring and other specialized subsidiaries providing a wide range of financial services. Several banks have interests in the so-called "intermediarias financieras" and/or in exchange-affiliated brokerage houses, and thus are already an important presence in the country's incipient securities market. Banks are the major issuers of CDs, and are active dealers in short-term commercial paper on behalf of their corporate clients. Most securities transactions initiated by banks and their financial subsidiaries are undertaken "over the counter".

Ecuador has two formal securities exchanges, both established in 1969 by the government development bank, Corporación Financiera Nacional (CFN). CFN is still the majority shareholder in the Guayaquil exchange and, with 30% ownership, is also the largest single shareholder in the Quito exchange. The volume of business conducted on the exchanges is quite small, currently averaging about U.S.$0.5 million per day in Quito, and about half that amount in Guayaquil. Well over half of the total volume transacted corresponds to bonds issued by the Ecuadorian Treasury -- which by law are required to be offered through the formal exchanges -- followed by notes and mortgage certificates issued by the commercial banks and purchased, almost entirely, by the IESS. January through September 1992, only about one-tenth of one percent of the total volume of trades effected through the Quito exchange was made up of shares.

At present, there are 26 "seats" on the Quito exchange, including 6 seats held by government agencies such as the IESS, the Central Bank, the Treasury, CFN, etc. The exchange has several hundred shareholders and is thus not member-owned. As noted above, the largest single shareholder on both exchanges is the CFN, which has not been an active promoter of the further development of the exchanges since making its initial investment in the early 1970s.

In summary, the capital market, meaning the long-term obligations and equities segments of the securities market, is virtually non-existent in Ecuador today. To the extent that it exists at all, it is sustained on both the buy and sell sides by the public sector. Private sector intermediation through the securities exchanges (bolsas) is also, in significant measure, the creature of government edict.

However, the securities market includes an active money market which is primarily based on private sector issues. Most of the trading taking place in the money market occurs outside of the established exchanges -- primariiy "over the counter" among banks and "intermediarias financieras", which are licensed to deal in all types of securities, but are legally distinct from the "casas de bolsa" or brokerages that are members of an exchange.

The securities market is highly fragmented, with little business conducted between the two exchanges themselves, or between the exchanges and the OTC markets.

Regulation of securities market is also highly fragmented, with the Central Bank, Monetary Board and Superintendency of Banks having a high degree of influence on the operations of the money market; the Superintendency of Companies having nominal jurisdiction over issuers, the exchanges and exchange-affiliated brokers, and little or no regulation of OTC securities transactions taking place.

Much of the regulatory structure that does presently exist, especially at the Superintendency of Companies, is both ineffective and counterproductive, and serves as a retarding influence on the further development of the securities market. New legislation currently under development will, if passed in the near future, markedly improve the existing regulatory structure and provide an overall framework for market development over the next few years.

E. Legislative and Policy Scenario and Its Implications for an A.I.D. Assistance Program

As discussed elsewhere in this report, intermittent efforts to pass a Securities Market Law have been underway in Ecuador for over 10 years. The outgoing Borja Administration included draft securities market legislation as part of a broader financial sector legislative reform program, but was not able to get the whole program passed before transferring power to incoming President Durán-Ballén. The new government is also strongly in favor of such legislation, however, and the broad consensus on this subject which exists between the current Administration and the congressional opposition makes it reasonable to expect legislative approval of a new Securities Market Law in the near term, as well as other supporting and closely-related legislation in the areas of: privatization; companies law; financial institutions law; income tax, and social security.

Key desirable and likely features for the new Securities Market Law include:

- establishment of an independent National Securities Commission (Comisión Nacional de Valores, CNV) with regulatory authority over the issuance of securities and their offer to the public, the securities exchanges, affiliated and non-affiliated brokers, publicly held companies, investment advisors and investment companies;

- legal recognition of a permanent over-the-counter market, as well as of the Quito and Guayaquil exchanges;

- conversion of the two exchanges into self-regulated, non-profit entities owned by the member brokers; creation of a self-regulating mechanism for intermediaries not affiliated with either exchange through a Self-regulatory organization; regulatory approval and oversight of exchange and SRO rules by the CNV, and

- recognition of the importance of commercial banks in the future development of the securities market, by allowing banks to own and operate exchange-affiliated or OTC brokerages, investment banking/advisory houses, investment companies, etc.

Key desirable features of accompanying legislation would include:

- establishment of clear criteria, procedural mechanisms and authority to initiate a privatization program expected to affect a wide range of public enterprises and public services;

- simplification of various features of existing companies law to facilitate company formation, voting rules, share transfer and other activities that are of relevance for capital market development in Ecuador;

- enhancement of financial institutions law to establish the right of banks and other financial intermediaries to own brokerage and/or investment management subsidiaries, to regulate bank-affiliated securities market operations, and to allow the indexation of financial instruments;

- revision of corporate tax law to allow consolidation of income tax returns for affiliated companies and eliminate other biases in favor of debt vs. equity financing that may continue to exist, and

- establishment of private pension-fund management companies, and transfer of all or part of pension funds currently managed by the Social Security Institute.

F. Proposed USAID Capital Markets Development Strategy

Numerous features of A.I.D.'sgeneral development strategy are essential to the development of an efficient and effective capital market in Ecuador. Key elements of the general A.I.D. program include:

- assistance in macroeconomic and financial sector policy development/policy dialogue;

- assistance in developing a competitive climate for domestic and international investment, and

- assistance in the implementation of privatization programs.

In this section, five specific strategic objectives for capital market development and recommended initiatives for achieving them are discussed.

1. Integrate the national securities market through mobilization of private sector initiatives and the completion of an interconnected, automated trading system

Principal Recommended Initiatives

- remove remaining restrictions on the participation of commercial banks in the securities market, so long as this is done through specialized subsidiaries and adequate protection for the banks' capital are enforced;

- incorporate the two securities exchanges in the national market system, preserving their identities as separate "boards" and maintaining their individual autonomy in terms of ownership, self-regulation, commissions and listing requirements;

- establish an association to provide a self-regulatory structure for over the counter intermediaries not associated with either exchange;

- establish a central depository and settlement system for listed securities in order to immobilize securities, speed settlement and provide greater safety for market participants, and

- reduce direct participation of the government in securities markets operations through the sale of CFN participations in the two exchanges and reduction of the regulatory role of the Superintendency of Companies with respect to companies offering securities to the public.

Comments

The development and effective functioning of specialized securities markets institutions -- including trading facilities, information systems, brokerage services, investment advisory services, investment management services, custodial and transfer services, etc. -- require that a sufficient volume of transactions exist to permit the recovery of associated costs within a competitive framework, without imposing an excessive burden on transactors. Ecuador begins with a very small market which is presently not capable of sustaining the required degree of specialization, partly because of the excessive fragmentation that exists.

Ecuador's universal banks are by far the major players in the OTC money market, as noted above, and they are clearly the strongest and most technically advanced financial institutions in the market. Limiting their participation in the securities business -- beyond ensuring that adequate protections are instituted to keep such business from exposing bank depositors to inappropriate risks and ensuring confidential treatment of information on issuers and investors -- would not only be unrealistic, but would deprive the market of access to the major source of development resources and expertise that is available. As is already the case in Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Panama and Peru -- not to mention most of Western Europe and Japan -- Ecuadorian banks should be free to participate in the securities markets through ownership of exchange-affiliated or independent brokerage houses, the ownership and management of investment companies, investment advisory companies and banks, etc.

A self-regulatory structure such as the NASD is needed to ensure that adequate ethical and prudential standards are adhered to by OTC intermediaries. Like the two formal exchanges which also directly regulate the activity of their members, the new self-regulating organization should be subject to the rules and jurisdiction of the CNV.

Finally, a central depository and settlement system is suggested not only for its ability to speed up the settlement of securities transactions, but for its role in promoting the integration of a national securities market in Ecuador. Transactions in securities held at the central depository will rightfully be perceived by market participants as being safer. This, along with the reduced cost of transactions, should generate secondary trading volume and liquidity for them. The existence of a central depositary will facilitate the development of reliable market information systems, and will encourage standardization in securities issued.

2. Mobilize medium- and long-term resources for investment through the securities market

Principal Recommended Initiatives

- implement pension system reforms -- at a minimum upgrading the investment policies and practices of the IESS, and possibly extending to the full or partial privatization of pension fund management;

- authorize the creation and public offer of indexed financial instruments -- including double indexation for housing finance -- as means of providing savers with increased protection against inflation;

- reduce entry and exit barriers, and the discriminatory taxation of foreign portfolio investment capital, and

- facilitate the organization of mutual funds and other investment company products to mobilize domestic and flight capital for investment.

Comments

Issuers will only come to the market, and institutions to serve them will only develop, to the extent that the capital market is able to provide a clear advantage in terms of access to medium- and long-term financing for issuers and liquidity for investors. Development of the investor side of the market, particularly among institutional investors with the resources and staying power to provide long-term financing, is crucial to the development of the market. Absent the participation of such institutional investors, little will be gained from legislation, regulatory reform or the institutional development of the market and its intermediaries.

3. Establish a clear, uniform and transparent regulatory framework for the securities market, with adequate institutional resources and authority for effective market supervision and enforcement

Principal Recommended Initiatives

- establish an independent National Securities Commission to regulate the activities of market participants, including companies offering securities to the public, brokers, exchanges and self-regulatory bodies, and

- revise companies laws and bank laws to facilitate the offer of shares, and ease their transfer through trading on the market.

Comments

Little needs to be said in regard to the regulatory environment that has not been adequately covered in the series of analyses and consultant reports cited in Chapter III, above. We draw attention once again, however, to the need to address continuing deficiencies in the companies and foreign investment laws that discourage the development of an active equities market, and to the need to develop a regulatory framework for the securities market that is consistent and comprehensive in relation to other regulatory provisions governing the banking sector and commercial activity.

Inter-institutional measures will need to be taken to ensure that the minimum of well-conceived regulation needed to maintain competition and transparency in the market is, in fact, implemented and enforced.

4. Promote the development of a "culture" or market psychology that is more sophisticated and attuned to securities market operations, through communications programs aimed at the general public, seminars, and specialized training for corporate treasurers, market intermediaries, accountants/auditors, and regulators

Though self-explanatory, the importance of educational and promotional activities for the development of the securities market cannot be overstated. Participants not only need to understand that the market can be developed to serve their presently unmet needs, but also need to be aware of the conditions that must be put into place and the requirements that will be placed on them in order for the market to develop and function as intended.

5. Facilitate the development of market systems and institutions, including, for example, investment banks and advisors

As transactions volume grows, there will be a need for the development of a broader range of instruments and a greater diversity of market institutions to provide specialized services to issuers and investors. A capital market development program should recognize the need for such institutions, and ensure that conditions for their timely development are put into place.

Chapter VI., below, outlines a capital market development implementation plan for USAID/Ecuador, Fundación Ecuador, and the Stock Exchanges of Quito and Guayaquil which is structured around the initiatives identified above.

VI. IMPLEMENTATION PLAN

In order to carry out the initiatives outlined above, the team proposes the following implementation plan. The most immediate effort is to form a leadership committee. Its role will be to carry out efforts supportive of capital market development, with or without passage of the capital markets law.

This section first outlines the purpose, composition and activities of the leadership committee. It then proposes an action plan to implement some of the key initiatives proposed in our capital markets development strategy.

A. Form a Committee

The first step in the implementation plan is to form a senior level committee which will take ownership of and provide leadership to the process of capital market development.

1. Purpose

The committee will pursue the following five objectives:

- develop the market from within Ecuador;
- involve the private sector and government in dialogue;
- facilitate unification of the fragmented market;
- provide continuity, and
- focus actions to develop the market.

2. Composition

It should have no more than ten members and have private sector leadership. Its private sector membership should be drawn from the exchanges and brokerage firms, the banks, and other financial institutions.

Key to its success is that the group must be a true working group with active participation and contribution by its members. It should hold frequent meetings and be funded through the Fundación Ecuador, although it will remain autonomous.

3. Activities of Committee

The two main responsibilities of the committee will be 1) to conduct analyses and policy dialogue and 2) to develop and carry out an action plan. The committee's analytical and policy dialogue roles are discussed in this section.

The group will employ several means to implement its analytical and lobbying activities. It will:

- identify issues;
- conduct/direct analyses, and contract research and studies;
- organize roundtables to discuss issues, and
- lobby for passage of initiatives as a united voice.

It will hold senior level roundtables to develop consensus for policy dialogue and action plans, and design a program to promote the market.

Given the serious need for legislation to support capital market development and privatization, reform the pension fund system and promote foreign investment, a significant level of effort should be placed on supporting the passage of critical laws and regulations. Policy dialogue should consist of, but not be limited to:

- lobbying for passage of the Capital Markets Law;
- designing changes to and lobbying for passage of modifications to the Companies Law which would reduce to role of the Superintendency of Companies regarding public companies, allow additional types of financial instruments, and make the changes required to put in place a central depository systems;
- designing alternatives for reform and lobbying for change of the pension system;

- determining obstacles to foreign investment, including the need for reforming the foreign investment law and the need for a tax treaty with United States; lobby for approval;
- providing supporting evidence from other countries' experience of viability of indexing and lobbying for passage;
- investigating and lobbying for appropriate methods for introducing additional investment vehicles such as mutual funds; determine legal obstacles, and
- assuring freedom of entry into the market for institutions such as casas de bolsa, subject to regulatory criteria designed to protect investors.

4. Technical Assistance Requirements

Through USAID/Quito and the Fundación Ecuador, short-term consultants should be contracted in to make recommendations for policy dialogue, lend discipline to the process and perform research, as needed.

The types of consultants needed include investment banking/capital markets specialists, specialists in automated quotation and trading systems and central depository systems, specialists in pension reform/indexation, legal specialists for reform of companies law and foreign investment laws, and mutual funds specialists.

B. Develop and Carry out Plan of Action

Concurrent to policy dialogue efforts, the leadership committee will develop a plan to accomplish the objectives set forth above and build consensus for the plan. Specific actions to be taken by Fundación Ecuador, USAID/Quito and the exchanges will depend on the plan devised, and of course, on the passage of legislation and other events that directly affect the market. The five examples of assistance to be provided depend on alternative scenarios and are representative of the initiatives presented in our strategic approach. Technical assistance, training and communications requirements are suggested for each example.

Objective: **Integrate the market.**
Initiative: **Develop a computerized, national market system and a central depository system.**

Through technical assistance, training and communication, the USAID and Fundación Ecuador can help facilitate this process. Expertise can be drawn from individuals with experience in establishing markets in developing countries and from organizations that have experience with "upstairs" trading systems such as NASD, the Midwest Stock Exchange, the Vancouver Stock Exchange or similar organizations.

Steps to be taken include:

- analyze legal and market impediments if a computerized market is developed without passage of the Capital Markets Law;
- develop an organizational structure and business plan, including cost projections;
- design technical specifications;
- analyze systems requirements and cost, and
- install systems.

Training can be provided in the operation of the system. Short-term overseas placement in NASD or with NASD members should be considered.

Complementing these efforts should be a communications initiative focused on market intermediaries, the private productive sectors and the public. Seminars and a publicity campaign to promote awareness of the system should be considered.

Objective: Mobilize Medium and Long-term resources
Initiative: Reform the pension system

Technical assistance in the following areas should be provided:

- analyze alternatives for reform, ranging from improved investment policies and practices to privatization of social security retirement fund management;

- assist in the establishment of investment policies and prudential investment rules for pension funds;

- analyze alternate means for monetary management by the Central Bank that do not restrict discretionary powers of pension fund managers, and

- assist in establishing the regulatory framework for operation of pension management system.

Portfolio management training for pension fund managers and training in pension fund supervision should be considered, as well as regulation for regulatory authority. A communications effort should be undertaken to explain changes in the pension system. This should include a public information campaign as well as seminars for public and private sector managers to explain the operations of the new system.

Objective: Establish a regulatory framework
Initiative: Develop a self-regulatory organization and the CNV

Regulatory experts (short or long-term) with NASD/SEC experience can work with the CNV, the banks and the exchanges to:

- develop SRO rules and a consensus for the SRO method of operation;

- develop CNV division functions; develop a one-year and a five-year plan for each division; assist in rule writing process;

- develop a comprehensive surveillance and enforcement program, including SRO and CNV;

- at a later stage, consider development of an accounting profession, emphasizing enforcement of standard accounting principles.

In country, one-on-one training with each division chief of the CNV should be considered as well as overseas training tours and internships with U.S. SEC and NASD.

Objective: Promote a Market "Culture"

The USAID and Fundación Ecuador can provide technical assistance to develop a training and communications program to build awareness of the capital market. Training for market intermediaries, accountants and regulators should be considered, as well as a communications program through public media and seminars.

Objective: Develop Market Institutions

Experts in portfolio investment, the creation of new financial instruments, brokerage services, venture capital funds and mutual funds should be provided. In order to streamline efforts, the specialists could provide one-on-one assistance through a competitive program that provides assistance to organizations that provide the best proposals. Outside experts could also work with the Ecuadorian private sector to devise methods of encouraging joint ventures with foreign investment banks.

Seminars could be provided for financial intermediaries in topics such as retail marketing, structuring of investment alternatives, underwriting, investment club formations, brokerage firm operations, mortgage-backed securities, mutual funds, securities market operations, portfolio investment, or venture capital.

Specialists could work with universities to create courses in portfolio investment, financial analysis, securities market operations. A train-the-trainer program could also be developed.

Appendix A

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Appendix B

PERSONS INTERVIEWED

QUITO

Bankers

Antonio Acosta	Banco del Pinchincha
Jaime Acosta Velasco	Banco del Pinchincha
Juan Crespo	Banco del Pinchincha,
Abelardo Pachano	Banco de la Producción

Brokers and Stock Exchange

Jose R. Borja P.	INVESTBAN
Fernando Bueno	INVESTBAN
Roberto Bustamante Ponce	CODIFI S.A.
Alberto Dorfzaun	INVESTBAN
Jorge Cornejo Proano	Bolsa de Valores de Quito
Edison Ortíz Durán	Bolsa de Valores de Quito

Accountants/Auditors

Anthony Dawes	Price Waterhouse
Beatríz de Mena	Price Waterhouse
Rita Padilla	Price Waterhouse
Rolf Stern	Stern & Compañía

Public Sector

Fabian Albuja	Superintendent of Companies
Augusto de la Torre	Banco Central del Ecuador
Ana Lucía Armijos	Banco Central del Ecuador
Eduardo Checa Comacho	CONADE
Mario Ruiz	Junta Monetaria
Leonardo Stagg	Corporación Financiera Nacional
Luis Ramón Cuesta	Corporación Financiera Nacional

USAID/Quito

Edgar Guillén
Bob Kramer
Peter Lapera
Randy Reed
Jim Watson

GUAYAQUIL

Bankers

Danilo Carrera Drouet	MULTIBANCO, Banco de Guayaquil and Fundación Ecuador
Roberto Isaías	FILANBANCO
Marcel Laniado	Banco del Pacífico
Paul Palacios	Banco del Pacífico

Brokers and Stock Exchange

Modesto Correa	Bolsa de Valores de Guayaquil
Jorge Egas Pena	Bolsa de Valores de Guayaquil
Martin Fioravanti	FINANCORP
Romulo Gallegos Vallejo	Bolsa de Valores de Guayaquil
Jorge Morán Centeno	Bolsa de Valores de Guayaquil
Vicente Muñoz S.	FINANCORP S.A.,
Juan Carlos Zevallos	Cobolsa, C.A.

Private Productive Sector

Jorge Gallardo	Former Minister of Finance
Fausto Idrovo	Grupo Suizo
Jose Larrea	Cemento Nacional
Ernesto Noboa	Camara Industrias
Francisco Ruete	Fábrica de Aceites La Favorita S.A. and Argentine-Ecuadorian Chamber.
Segundo Wong Mayorga	REYBANPAC
Rafael Wong Naranjo	REYBANPAC
Vicente Wong Naranjo	REYBANPAC
Juan Carlos Zurita	REYBANPAC

Fundación Ecuador

Pedro Aguayo Cubillo	Executive Director
Alberto Yepez F.	Economist

SCOPE OF WORK

I. GENERAL BACKGROUND

The Trade and Investment Project (T&I; project (518-0094) is a six year, $10 million project which supports Ecuador's evolution toward greater reliance on export-oriented growth, privatization and capital market development. The project goal is to support achievement of broad-based, sustainable economic development. The project purpose is to provide quality export and investment services and support the institutional development of a viable Ecuadorian trade and investment organization. Capital market development has been identified as one of the key means of attaining these goals.

The project consists of three components: (1) export promotion; (2) investment promotion; and (3) institutional development and policy dialogue. Project funds are channeling assistance for the creation of a new, permanent organization, Fundacion Ecuador. It is anticipated that the new Foundation will assume responsibility for the project, under a Cooperative Agreement, and to take on a broader role in promoting trade and investment in the Ecuadorian private sector. It is further expected that Fundacion Ecuador will assume a major role in promoting continued policy reform on trade and investment issues with the Government of Ecuador (GOE), including a number of activities in support of privatization and capital market development, defined in the broadest terms, namely as increased private sector participation in the Ecuadorian economy. It is hoped that a more developed capital market will stimulate increased private investment and provide the financial resources to support an expanding private sector.

Privatization and Capital Market Development

In January, 1992 Fundacion Ecuador (in close collaboration with USAID/Quito) initiated activities to broaden the understanding of the concept of privatization and develop the capital market in Ecuador.

Key components of Fundacion Ecuador's assistance to the next government (August 1992) through the development of the "Economic Policy Agenda of the Nineties" are privatization and capital market development. Economic reform (privatization/capital market) implementation assistance is predicated upon the next government not only publicly promoting privatization and capital market development initiatives, but more importantly, gaining Congressional approval of privatization and capital market legislation. This legislation will, inter alia, authorize establishment of legal procedures and an operational structure for implementing privatization transactions, e.g., management contracts, leasing of state-owned companies, privatization investment funds, employee stock ownership plans and other programs to achieve greater private sector competition and widespread ownership in Ecuador.

During the period from February to June 1992, USAID/Quito provided a legal advisor (via the Securities Exchange Commission, Washington, D.C.) to the Presidential Working Group preparing a new Capital Markets Law. A final draft was delivered to President Borja (June 1992) for submission to Congress prior to his departure from office. In the event this Law is not approved prior to August, it is expected that the next administration will refine the Law and request that Congress approve or disapprove it between September and November, 1992. The purpose of the requested technical assistance is to work with the Fundacion Ecuador to undertake capital market initiatives which will initially focus on assisting the Bolsa de Valores (Stock Exchange) in Quito with upgrading and expanding its services and staff capabilities, i.e., training of key personnel, improving accounting and audit standards, and enhancing the capabilities of the Ecuadorian underwriting firms. It is anticipated that following this Contract, additional assistance may be directed to the Bolsa de Valores in Guayaquil.

The proposed Capital Markets Law authorizes the establishment of a regulatory agency (Comision Nacional de Valores, CNV) to oversee the stock exchanges in Quito and Guayaquil. Upon passage of the law, it is anticipated that Fundacion Ecuador will allocate significant technical assistance to assist in the creation of an organizational and management structure, promulgating new operational procedures and administrative legislation, recruitment and selection of senior CNV management, and designing appropriate training programs for CNV staff. CNV will be empowered to establish new accounting and audit standards, underwriting standards, and criteria for brokerage firm licenses. It is expected that Fundacion Ecuador's provision of substantial technical assistance and training programs will assure successful implementation of the new Law.

II. USAID OBJECTIVES

The T&I Project, under which the Fundacion Ecuador Cooperative Agreement is being funded, contributes to USAID/Quito's Strategic Objective No. 1, "Increased trade and employment in nontraditional exports". The Cooperative Agreement includes, inter alia, financing activities that directly contribute to the following Program Outputs under the Strategic Objective No. 1:

1. Increase in investment in non-traditional export industries;

2. Improvement in the trade and investment climate;

With respect to the second program output, USAID/Quito is seeking to increase the amount of domestic and foreign investment with the design and implementation of privatization and capital market development programs in addition to supporting Fundacion Ecuador-led investment and export promotion programs.

III. CONTRACTOR SERVICES

The Mission contemplates a contract with a consulting firm specializing in capital market development for the services required to prepare a capital market sector development strategy/diagnostic plan. The Contractor will evaluate USAID/Ecuador's prior assistance to the capital market sector. It is expected that the Contractor will recommend the level and form of additional assistance that would be appropriate for A.I.D.

IV. STATEMENT OF WORK

The following activities should be included in the Contractor's work. However, they are not to be considered all-inclusive or restrictive in nature, and do not constitute relief from exercising due professional care and judgment.

A. Evaluation of USAID/Ecuador Prior Support to the Capital Market Sector.

The Contractor is required to conduct a review and an assessment of prior technical and financial assistance to the Ecuadorian financial market sector during the period 1985 to 1992 furnished by USAID/Ecuador, World Bank/IFC, and Interamerican Development Bank. This assessment will include a desk review of studies and literature existing in the Mission's files and library.

B. Preparation of a strategic plan for the development of the Ecuadorian capital market. The plan should include the role, actions, and activities which should be undertaken by principle implementing agencies and/or participants in supporting capital market development: Fundación Ecuador, USAID/Ecuador and Bolsa de Valores (Stock Market) in Quito, Ecuador.

C. Preparation and implementation of a questionnaire/survey for a detailed interview of 20-25 companies and related institutions that are currently using, or expect to use in the next two years, the Ecuadorian stock exchange as an important means of equity and debt financing.

The Contractor is required to prepare a detailed strategic/diagnostic plan that recommends specific actions and activities that Fundacion Ecuador and USAID/Ecuador can take to develop the Ecuadorian capital market sector. Emphasis must be given to formulating alternative methods of expanding investment, particularly through the Bolsa de Valores in Quito.

The Contractor's proposed strategic/diagnostic plan should identify additional counterparts in the Ecuadorian government and private sector that are capable of achieving Fundacion Ecuador and USAID/Ecuador's economic development objectives set forth in the Fundacion Ecuador Cooperative Agreement and USAID/Ecuador's FY1993/1994 Action Plan and current Country Development Strategy Statement. For example, the Government of Ecuador (GOE) owns 70 per cent of the Bolsa de Valores in Guayaquil, Ecuador through its Corporacion Financiera Nacional. The contractor should assess and recommend appropriate technical assistance to Bolsa de Valores/Guayaquil assuming ~~privatization~~ is a condition precedent to allocating future A.I.D. resources to this stock exchange.

D. Given the dynamic nature of the legal and regulatory environment and pending legislative reforms, provide USAID/Ecuador and Fundacion Ecuador with recommendations regarding next steps. This will include the appropriateness and potential effectiveness of several possible initiatives contemplated for the coming year.

V. Reports

The Contractor will be required to submit a work plan to Fundacion Ecuador and USAID/Ecuador for approval within one week of arrival in Ecuador. During the course of the consultancy, the Contractor will brief USAID/Ecuador on the progress of the assignment and shall hold an exit briefing to explain findings and offer recommendations. Five copies of the draft final report shall be submitted, in English, within 30 days of departure from Ecuador. Five copies of a Spanish translation shall be prepared and submitted within 15 days thereafter. The Contractor shall prepare and submit five copies of the final report, in English and Spanish, within 15 days of receipt of comments on the draft finals (English and Spanish) from USAID/Ecuador and Fundacion Ecuador.

VI. Relationships

For this contract, the clients are Fundacion Ecuador and USAID/Ecuador. The liaison officers will be Mr. Edison Ortiz, Member, Fundacion Ecuador Board of Directors and President, Bolsa de Valores in Quito, Ecuador and Mr. James Watson, ~~Deputy~~ Director, Office of Export, Trade and Investment of USAID/Ecuador for programmatic concerns and Ms. Norma Pineda, Acting Controller of USAID/Ecuador for issues related to accounting and management systems.

VII. Terms of Performance

The effective date of this contract will be the date of the AID/Washington Contracting Officer's signature. The work shall begin as soon as practicable after signing of the contract, and from the start date, the Contractor should submit to USAID/Ecuador: (a) the complete work plan in writing within one week of arrival in country; (b) the required copies of the draft final report within 30 days of departure from Ecuador.

VIII. Key Personnel

It is understood that the persons who will do the work will be submitted in advance of commencement of work as part of the Contractor's proposal. Fundacion Ecuador and USAID/Ecuador must concur with the proposed personnel.

IX. Logistic Support

The Contractor will provide the physical structure, office space, equipment, etc., for the work to be performed under this contract. However, Fundacion Ecuador, USAID/Ecuador and Bolsa de Valores in Quito, Ecuador will provide backup logistic support as necessary.

X. Work Week

The Contractor will be authorized a six day work week.

bolsa:jw:6/19/92rev.6/28/92

M E M O R A N D U M

December 21, 1992

TO: Barbara Friday
Financial Sector Development Project
Price Waterhouse

FROM: Phil Rourk
AG International

SUBJECT: Trip Report -- December 6 to December 12, 1992
Ecuador Capital Market Development Project

The one-week trip to Quito and Guayaquil was undertaken for three primary purposes: 1) to gather comments from USAID/Ecuador and other participants in the Ecuadorian Capital Market Development Process on the contents of Price Waterhouse's draft report, dated November 1992; 2) to assess progress, especially with respect to drafting of a new Securities Market Law, and assist in the finalization of a Scope-of-Work for a FSDP buy-in from USAID/Ecuador, for a wide range of capital market development services to be rendered between January and September 1993; 3) to assist in the recruitment and organization, through the Fundación Ecuador, of suitable individuals to participate in the Ecuadorian Capital Market Development Committee, the principal counterpart for FSDP technical assistance under the proposed buy-in. All three purposes were significantly advanced through the mission, as indicated in more detail below.

Comments on the Price Waterhouse November draft report were gathered through discussions with USAID Project Officer, Mr. James Watson (marginal notes provided by Mr. Watson were transmitted to PW on December 16); a meeting held in Quito on December 8 with responsible Mission staff; a meeting held in Guayaquil on December 9 with the Fundación Ecuador, and written comments received from the FE (Attachment 1 to this trip report); a meeting held with officers and members of the Guayaquil Securities Exchange on December 9; a meeting held with Mr. Rolf Stern of Stern & Cia. on December 10; and, a meeting held with Quito Securities Exchange President Mr. Edison Ortiz on December 11.

In general, comments received on the draft report were complimentary. The proposed strategy it contains was considered sound by all key reviewers, and it has been accepted as a useful basis for structuring a medium-term development program that would begin with the proposed FSDP buy-in. Fundamental elements of the strategy that have been specifically endorsed include:

- emphasis on market integration, in part through increased automation and the creation of centralized facilities;

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- rapid deployment of technical assistance in key aspects of securities market regulation following approval of the long-awaited new Securities Market Law;

- organization of an Ecuadorian Capital Market Development Committee to lead the market development process.

A meeting was held on Monday, December 7, with Mr. José Mantilla, Junta Monetaria Advisor responsible for coordinating the Administration's drafting of the new Securities Market Law. Detailed notes of that meeting are presented as Attachment 2 to this trip report. In general, the following are key indicators of the new law's progress:

- passage is expected in early 1993; careful preparations are being made for its submission and review by Congress, even though no significant organized opposition is expected;

- regulatory provisions are expected to reflect advice received by the GOE from U.S. SEC and British experts, though it is not yet clear whether the new securities commission will continue to operate from with the Superintendencia de Compañías, or if it will be granted autonomous status;

- the law is expected to directly address the removal of existing barriers-to-entry into the membership of the exchanges, though this remains controversial for some current exchange members;

- the regulation of banks' securities market activities remains a difficult area, where guidance will probably continue to be required after passage of the new law, and where probably only experience gained through practice in the enforcement of that law will provide an effective set of rules that is fully adequate for the Ecuadorian situation.

With reference to the last point, Mr. Mantilla indicated a need for some immediate guidance, which was provided through contacting Mr. Paul Nelson of Price Waterhouse's Regulatory Advisory Services Group (see Attachment 3).

Considerable progress was made in developing a proposed Scope-of-Work for an FSDP buy-in (see Attachment 4). A draft scope-of-work prepared by FSDP Deputy Director Barbara Friday was reviewed in detail with USAID and FE staff, resulting in further focussing the proposed technical assistance activities on two key areas (securities market regulation, and automation), but which was otherwise accepted virtually in full. The draft contained in Attachment 4 should serve as an adequate basis for the preparation of a PIO/T and the development of a technical assistance budget for the period between January and September 1993.

After extended discussions and some apprehension, a viable approach to the organization of the proposed Capital Market Development Committee was developed in the latter part of the week. This approach entails a two-staged process:

1) organization of a small, very high-level, "entrepreneurial" Interim Committee to launch, promote and organize the process through its start-up phases;

2) transition to a more formal and representative permanent committee over a period of about six months.

The above approach will enable the capital market development effort to benefit from the concentrated, intensive participation of a few top financial sector leaders during the critical start-up phase -- without requiring an indefinite commitment to the process from these leaders. Also, the group can assemble and operate on a much more informal and less bureaucratic basis than will necessarily be the case at a later stage, when the committee will inevitably grow in size and complexity in response to the need to ensure a broad spectrum of participation from financial sector representatives.

It was agreed, following much discussion, that a purely private sector membership for the Capital Market Development Committee is preferable to the mixed composition suggested in the PW draft report. Permanent liaison with key government officials would be established and maintained, but the Committee, which may need to operate over a period of several years, will strive to avoid any possibility of partisan political restrictions or influences.

Mr. Edison Ortíz, President of the Quito Exchange, has committed himself to serve with the Interim Committee, and to assist in the recruitment of its other founding members. The Fundación Ecuador will also participate in the organization of the Capital Market Development Committee, in its interim and permanent phases. Early in the process of the committee's organization, it is expected that a full-time Executive Secretary will be recruited, to provide it with greater continuity and follow-up capability.

In light of the above, it was agreed with the A.I.D. Project Officer that another one-week mission in late January would be appropriate. The purpose of that visit will be to work closely with Mr. Ortíz and other members of the Interim Committee in developing a detailed work plan for the first several months of FSDP activity. It is not known whether a buy-in can be fully implemented by late January, but Mr. Watson indicated that other sources of support for this mission would be found, if necessary.

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Attachment 1.

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FUNDACION
ECUADOR

Diciembre 8 de 1992

Comentarios sobre el desarrollo de Mercado de Capitales en el Ecuador.

Sobre el reporte mismo se puede decir que es muy objetivo tanto en el aspecto de análisis pasado como en el análisis de proyección en lo referente al desarrollo del mercado de valores, pero lo que si esta muy claro y objetivo es en establecer los vacíos y las necesidades de este mercado de valores tiene, tanto en lo legal como en lo técnico y también en el aspecto de conocimiento y difusión de este nuevo sistema de inversión en el país.

Frente a este problema y con los objetivos que tiene la Fundación se puede establecer que esta institución tiene que jugar un rol muy importante en el desarrollo de mercado de capitales en el aspecto legal, técnico y promocional de este sistema, y el rol de la Fundación la podríamos de la siguiente manera:
definirlo

LEGAL.-

Promover las reformas legales de las diferentes leyes y la nueva ley que regulara el mercado de valores tales como: Ley de Companias y de Bancos, Ley de Inversión Extranjera, Ley de Mercado de Capitales, Ley de Pensiones etc.

Realizar y llevar adelante el Dialogo Polico como una arma fundamental para la aprobación de las reformas o de las nuevas leyes.

Fortalecer y dar soporte a las instituciones que están involucradas en el desarrollo del mercado de valores con o sin ley, y así seguir promocionando los organismos que mas tarde serán los reguladores y los participantes en este mercado.

TECNICO.-

-Contratación de consultores de corto-largo plazo como sean necesarios, en aéreas tales como: Mercado de Valores, Nuevas inversiones,, Automatización del sistema, Auditoría y control etc.

-Desarrollo de la organización y estructura del cuerpo Directivo/Regulatorio del Mercado de Valores, desarrollando un plan estratégico de corto-largo plazo.

- Automatización completa del sistema que permita tener toda la información necesaria para la participación clara y transparente en el mercado de valores, como: información histórica y presente, proyecciones, clientes, volúmenes de transacción etc.

Guayaquil: V.M.Rendón No. 401 y Córdova, 5to. Piso - Teléfonos: 300390 - 300359 Fax: 300344
Quito: Juan León Mera No. 130 y Av. Patria, 5to. Piso - Teléfono: 527292 Fax: 506570

FUNDACION ECUADOR

- Instalación de un sistema de control Contable y de Auditoría que de confianza y claridad a todas las transacciones realizadas.

PROMOCIONAL.-

Desarrollo de seminarios para participantes en el mercado de capitales, el publico y demás instituciones participantes o que deben participar en el mercado de valores.

- Viajes de Observación local-exterior de el personal que se encuentra involucrado en el desarrollo del mercado de valores y así crear una nueva cultura financiera en el país.

Con todo lo antes mencionado creemos que fundación Ecuador puede dar un aporte muy significado en el desarrollo de mercado de valores.

Guayaquil: V.M.Rendón No. 401 y Córdova, 5to. Piso - Teléfonos: 300390 - 300359 Fax: 300344
Quito: Juan León Mera No. 130 y Av. Patria. 5to. Piso - Teléfono: 527292 Fax: 506570

Attachment 2.

Jose E. Mantilla
Capital Markets Advisor, Junta Monetaria

Monday, December 7, 1992

Present at the meeting were Messrs. Mantilla of the Monetary Board, James Watson of USAID/Ecuador, and Phillip Rourk of the Price Waterhouse Capital Markets Advisory Team.

Mr. Mantilla has been designated by Junta Monetaria President, Roberto Baquerizo, to oversee the process of drafting and legislative approval of a new Securities Market Law for Ecuador. The law is in the final drafting stages, and is planned for submission to the Presidency of the Republic the week of December 14. It is not expected that the President's advisors will request any further significant changes -- as they have participated closely in the drafting process to date -- and the plan is to submit to Congress early in January. Again, the hope is for rapid approval with few modifications. A thorough public information and lobbying effort is being planned to help ensure that this will be the case.

Following are some the salient features of the proposed legislation, as reported by Mr. Mantilla.

1. <u>Creation of autonomous CNV</u>. The draft law contains language establishing an independent Comision Nacional de Valores, which is to have 7 members, 4 from the government and 3 from the private sector. While it is probably a prudent choice not to try to downsize/restructure the Superintendencia de Companias to have it assume a securities market regulatory role, the creation of the CNV is likely to attract criticism merely due to the fact of the creation of a new governmental entity during a period in which public sector downscaling is the cry. The new CNV will require significant levels of technical assistance during the first two years of its existence, as would have the Superintendencia de Companias if it had been assigned a regulatory role in the Securities Market Law.

2. <u>Full participation of commercial banks.</u> Commercial banks are to be allowed up to 100% ownership of "casas de bolsa", which are discussed further below, and, through these subsidiaries, unrestricted participation in the securities market.

3. <u>Creation of investment banks or "Casas de Bolsa".</u> The new law establishes the "casa de bolsa", which was described by Mantilla as being akin to an investment bank. A full range of brokerage and trading services, including margin credit, are to be provided. The "casas de bolsa" will also be allowed to underwrite the issue of securities, establish positions and trade for their own account, and market mutual funds and other investment vehicles. Advisory services may also be offered by them.

4. <u>Unrestricted membership in the exchanges.</u> To the probable chagrin of existing exchange-affiliated brokerages in both Quito and Guayaquil, the new law will require that exchanges open their membership to all brokers that meet stipulated requirements.

5. <u>Requirement that market institutions be members of an exchange.</u>

Balancing the above, is the requirement that all intermediaries, including the new "casas de bolsa", be affiliated with a recognized exchange, and thus be subject to capital adequacy and ethical rules established by the exchanges. As

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indicated below, however, exchange members will not be legally required to transact any of their business on the exchanges.

6. Creation of centralized depository and clearing system. The law will provide for a centralized depository, to be housed at the Central Bank of Ecuador, and managed by a mixed public/private sector corporation that is yet to be established. The depository institution is envisaged to provide other services related to accounting, clearing and settlement -- perhaps trading as well -- that are expected to be a major motivating factor for the gradual integration of the market into a unified national system.

7. Freedom to transact over-the-counter. Intermediaries will be free to transact business over-the-counter, thus maintaining pressure on the exchanges to provide valued services. Until such time as a functioning SRO to regulate the over-the-counter market is established, however, this freedom to trade off the exchanges will potentially raise questions regarding trading practices.

8. Authorization of a Self-Regulatory Organization. A self-regulatory organization for the over-the-counter market is authorized in the draft legislation, but apparently constitutional questions have been raised that so far have not made it possible to make membership in the SRO compulsory. A potential loophole may exist in the new legislation in this regard, especially as regards bank interests in "intermediarias financieras", and the freedom of such intermediarias to transact securities of different types.

9. Tax incentives for stock issuance. The law will provide a tax deduction equivalent to the value of stock sold to the public, and a five-year tax rate reduction for certain companies (expected to be few in number) that meet certain ownership distribution criteria. The proposed incentives are less than those contemplated in previous legislative initiatives, and are expected to be primarily useful through their publicity value.

10. Creation of rating agencies. Rating agencies will be established under the new law, to regularly publish opinions on the financial condition of companies issuing debt through the securities market. New issues of debt will require rating by at least two independent rating agencies, and the CNV may require a third opinion, at its discretion.

11. No direct mention of pension system reform. Unlike previous legislative initiatives, the proposed new law does not attempt to address issues pertaining to the structure and management of the country's pension system. While pension funds are recognized to be important to the long-term development of the capital market, present drafters have wisely opted to leave the highly politicized subject of pension system reform to be addressed separately.

12. Authorization of both closed- and open-ended mutual funds. Both types of funds are recognized, and these may be organized, marketed and managed by "casas de bolsa", as well as, presumably, other established financial intermediaries.

13. Authorization of foreign investment funds. Foreign "country funds" are also authorized to operate in the Ecuadorian market, though details on the proposed treatment of such funds and their financial interests are not presently available.

The above provisions of the draft Securities Market Law are, in general, favorable developments and consistent with the recommendations of AID advisors, such as Lewis Mendelson and the Price Waterhouse team, and others, who have

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participated in discussions with the GOE on this subject. There are a small number of specific issues that have not yet been fully resolved by the draft legislation, and that will bear monitoring in the future.

14. Lack of explicit "firewalls". One problem, recognized by Mr. Mantilla, and slated for attention in the course of drafting a new Financial Institutions Law some time in 1993, is the lack of specific separation of the capital of the new "casas de bolsa" from that of the parent bank. Particularly in light of the wide-ranging powers being given to "casas de bolsa", including trading for their own account and the management of open-end mutual funds, it is essential that adequate protections be established to keep securities market operations from threatening the capital of the parent commercial banking company.

15. Need to clearly separate "money market" from "securities market" for jurisdictional and regulatory purposes.

Other than some distinctions based on the maturity of securities traded, the division between the "money market" and the "securities market" is somewhat hazy at the edges. Mr. Mantilla requested, and Price Waterhouse is attempting to provide, some guidance on language to be incorporated in the draft law to clearly demarcate its domain along this boundary. One concern of the Junta Monetaria is that too loose an interpretation of "securities" in the law could inadvertently affect ongoing established money market operations of the major banks, and thus generate resistance to the passage of the law unintentionally.

While this is a valid concern, it is felt that some degree of arbitrariness in defining the boundary between the two markets will be unavoidable. However arbitrarily, it is essential that the demarcation be clearly established in the Law, to avoid potentially serious problems arising from vague jurisdictional boundaries between the CNV and the Superintendencia de Bancos over a significant volume of "money market" business that is presently conducted by the banks.

16. Unregulated status of "intermediarias financieras". A related concern is related to the powers of "intermediarias financieras" to transact business in the securities market (including in stocks and long-term obligations of various kinds), and the capacity of the Superintendencia de Bancos to adequately regulate this business. Intermediarias financieras are owned by most major banks, but their status is separate from that of the proposed "casas de bolsa", being based on separate legislation that may require suitable amendments to avoid possible abuses over time.

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Attachment 3.

International Consulting Corporation
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Telephone 202 466 2950 FAX 202 466 2961

FACSIMILE COVER PAGE

FROM/DE: Phillip W. Rourk

PARA/TO: J. Richard Breen
FSDP Project Director
Price Waterhouse OGS

FAX NUMBER/NO.: (202) 296-2785

FECHA/DATE: December 7, 1992

TOT. PAGS./PAGES: 2

Dear Dick:

Things are off to a good start, with a very informative meeting this morning with the person at the Junta Monetaria that is managing the Securities Market Law drafting process. They hope to finalize the draft this week, obtain Presidential approval before the end of the year, and submit the law to Congress in January, where careful preparations are being made and prospects appear to be good for rapid approval.

An issue came up in the discussion, however, where they indicated that they could use some urgent assistance, and for which Jim Watson volunteered my and PW's assistance. This was, how to address commercial banks' involvement in short-term money market transactions -- both for their own account and for clients -- in the Securities Market Law.

Ecuadorian banks are universal banks, and the new law will give them full scope to participate in the securities market -- through wholly-owned brokerage/investment banking subsidiaries. Those operations will be subject to regulation by the exchanges and the new Securities Commission. Qua commercial banks, however, they are also expected to continue ongoing money market operations, and the authorities don't want to discourage this. Rather, the legislative drafters are concerned not to inadvertently affect this market in the new law, as doing so would needlessly generate opposition to the law from the banks. The drafters want to be able to establish a clear distinction in the new law between money market and securities market operations, so that money market activities can continue unhindered while longer-term transactions conform to the new legal requirements.

It's a fine line, however, and the Ecuadorians are seeking guidance on how to approach this issue -- other than through some arbitrary definition based solely on maturities. The demarcation they are looking for will also be important in establishing jurisdictional boundaries and responsibilities between the Securities Commission and the Bank Superintendency.

Do any of PWs other projects offer some guidance on this subject? Jim Watson seemed to recall that the issue came up in Jakarta, and that somebody named Evans may have done some work on it. Please let me know if there is anything useful available, and how quickly it could be sent down here either by fax or DHL. I am at the Hotel Alameda Real, Room 702, tel. (593) 2 562-345, fax (593) 2 565-759. If there is no extensive written material on the subject, but you would care to briefly offer your thoughts, those would also be welcome.

Thanks. I'll be looking forward to your reply.

Best regards,

Phil

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FACSIMILE COVER PAGE

FROM/DE:	Phillip W. Rourk
PARA/TO:	Mr. José E. Mantilla Asesor Junta Monetaria
FAX NUMBER/NO.:	570-258
FECHA/DATE:	December 11, 1992
TOT. PAGS./PAGES:	2

Dear José:

As discussed, attached please find an initial response to your request, prepared by Paul Nelson, from the Regulatory Advisory Services group at Price Waterhouse/Washington. I think it is quite helpful as far as it goes. I will get together with him early next week, however, and try to shed a little more light on some of the more complicated problems he refers to in his last paragraph, which I think should clearly be considered in the draft legislation you are working on.

Again, I enjoyed our discussion last Monday, and look forward to working with you again in the future.

Sincerely,

Phil Rourk

Phillip W. Rourk

copy: Mr. James Watson, USAID

A Subsidiary of THE AMERICAS GROUP, INC.

To: Phil Rourke

From: Paul Nelson
Regulatory Advisory Services

Date: December 11, 1992

Re: Ecuadorian Banks' Securities Operations

Dick Breen has referred to me your fax concerning Ecuadorian banks' securities operations. From my reading of the fax, your concern is how to separate the bank's activities on their own behalf in the money market from their activities on behalf of their customers. The goals seem to be to maintain a separation between bank regulation and securities regulation and to maintain banks' ability to manage their funds in the money market.

The U.S. regulatory system may be a good pattern for Ecuador. While they are not universal banks, U.S. banks can organize and operate broker dealers and deal in the securities markets on behalf of customers. The understanding is that when the banks undertake such securities market activities, they must comply with the regulatory system of the Securities and Exchange Commission. The SEC's regulations cover the broker dealer's capital, disclosure and recordkeeping requirements.

Banks' money market activities are subject to regulation by federal and state bank regulators. The bank regulators are concerned primarily with the activities' effects on the bank as an institution and whether the activities are conducted in a safe and sound manner. The bank regulators are concerned with the appropriateness of the banks' investments, their effect on liquidity and funding needs and their quality and their likely effect on bank capital.

There is likely to be a considerable overlap in a bank's investment for itself and a bank's investment for a customer. Thus, I agree that a regulatory system based solely on the maturity of investment would be unworkable. The better dividing line is likely to be by function. Regulation of securities activities by a securities regulator is appropriate when the bank is engaged on behalf of a third party customer. When a bank enters the securities market in its own name and for its own funding needs, it should be subject to regulation by its bank regulator on a safety and soundness basis. If the bank invests for customers as well as for itself through its broker dealer subsidiary, it should expect the broker dealer to be subject to a securities regulator's rules and its own investment portfolio to be reviewed in the bank by its bank regulator.

A regulatory system divided by maturities of investments would very likely result in some serious distortions. A maturities based system, for instance, could deny a bank investor access to a long-term money investment in either the money market or the securities market which might be necessary to match a similar long term certificate of deposit.

I hope this response is helpful to you. In preparing the response, I have deliberately kept to the simple assumption that a bank would be conducting all securities activities through a broker dealer. Thus, this response does not include a discussion of mor complicated problems such as banks' sales to customers from their investment portfolio, banks' sales of derivative products or repurchase agreements.

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Attachment 4.

I. BACKGROUND

USAID Ecuador is currently implementing a six-year, $11 million Trade and Investment Development Project to help increase Ecuador's reliance on market forces. In cooperation with a new private sector organization -- the Fundacion Ecuador -- and the securities exchanges (Bolsas de Valores) in Quito and in Guayaquil USAID is supporting capital market development. It is hoped that a more developed capital market will stimulate increased private investment and provide the financial resources to support an expanded private sector.

A recent Price Waterhouse consultancy provided USAID with an analysis of constraints to capital market development as well as a strategic approach and action plan. The following five objectives were established:

- Integrate the national securities market through mobilization of private sector initiatives and the completion of an automated trading system;
- Mobilized medium and long-term investment resources;
- Establish a clear, uniform and transparent regulatory framework;
- Promote the development of a securities market "culture";
- Facilitate the development of market systems and institutions.

In order to attain these objectives, the Price Waterhouse team proposed an implementation plan. The plan envisions an integrated program of policy dialogue, information dissemination and technical advisory services for implementation support. These services would be provided in coordination with an Ecuadorian leadership committee or working group.

Ecuador is currently in a crucial period of transition:

- a new government, committed to private sector growth and market mechanisms, took office in August 1992;
- a comprehensive Securities Market Law is to be presented to the Congress early in 1993, with rapid passage expected;
- a new institution, committed to private sector development (Fundacion Ecuador) has recently been organized;
- the CFN, a key public sector participant in both the Quito and Guayaquil exchanges, is divesting its shares in the exchanges;
- privatization of state-owned enterprises, including other holdings of the CFN, is underway.

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This project aims to build on this momentum and assist the Ecuadorian leadership meet the challenges of the changing environment.

II. OBJECTIVES

The objectives of this project are to facilitate:

- Policy Dialogue: to consolidate private sector initiatives to lobby for and support needed laws and regulations that would advance the process of capital market development;
- Information Dissemination: to increase the level of knowledge among practitioners and market participants through publications, seminars and/or roundtables;
- Implementation Support: to increase the skills base of market participants through the provision of specialists with hands-on experience in other emerging markets.

III. APPROACH

This project will have a three-pronged approach, as indicated above. By working with the Capital Markets Development Committee (CMDC), the Fundacion Ecuador and the securities exchanges in Quito and in Guayaquil, the project will consolidate and channel private sector support for key policy reforms. In order to disseminate information on the successful approaches undertaken in other emerging markets, and share practical experiences of other countries facing similar constraints to capital market development, the project will sponsor a limited number of publications and 2 or 3 roundtables or seminars. In order to facilitate implementation of highly technical initiatives, outside specialists will be contracted.

All three areas of the project are highly complementary and will be coordinated through USAID, the Fundacion Ecuador, PW/Washington, the securities exchanges, and the aforementioned Capital Markets Development Committee.

IV. SCOPE OF WORK

A. Policy Dialogue

The objective of this component is to consolidate private sector support for key public policy reforms, and successfully lobby for their implementation. The proposed policy dialogue will be conducted through a proposed new, private sector Capital Market Development Committee, which will also interact with USAID, the Fundacion Ecuador, the securities exchanges and PW/Washington in establishing an agenda for information dissemination and technical assistance activities undertaken to support implementation of capital market reforms. Specific objectives include:

- support passage of the Securities Market Law;

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- identify and overcome other legal and policy impediments to capital market development;

- advance the process of technological and institutional change.

Principal tasks include:

- organize the Capital Market Development Committee;

- prioritize issues;

- develop an action plan;

- set benchmarks, deadlines;

- determine and assign roles and responsibilities;

- organize roundtables, seminars;

- lobby for passage of the Securities Market Law;

- design changes and lobby for passage of modifications to the Companies Law and the Financial Institutions Law, in accordance with the private sector consensus on market development priorities generated by the CMDC;

- determine obstacles to foreign investment in Ecuadorian securities; design legal and regulatory changes needed;

- develop and lobby for constructive approaches towards the development of an efficient and responsible pension fund management system in Ecuador.

A multidisciplinary team will support this effort over an initial nine-month period, which may be extended for an additional one to two-year period depending on needs identified more precisely during the first stage. It is anticipated that the efforts of the advisory/technical assistance team will be more highly concentrated at the beginning of the first nine-month period, and will diminish to a steady-state level over time. A team of capital market and regulatory experts will work closely with the Ecuadorian Capital Market Development Committee, initially to assist in strategic planning through participation in monthly meetings, and later to help coordinate the program of seminars and technical advisory services to be facilitated through the project. A work plan for the organization of the Capital Market Development Committee, to be implemented by the Fundacion Ecuador immediately upon formalization of a Capital Market Development Program, is presented as Attachment B.

B. <u>Information Dissemination.</u>

Two or three one-day roundtables/seminars will be held, convening small groups of up to 25 private sector leaders in an exchange of information with practitioners from other emerging

- undertake training needs assessments, and design training programs in accounting, auditing, regulation and enforcement.

2. Design of an electronic, national market trading system and a centralized depository, clearing and settlement system.

Through technical assistance, training and communication, the USAID and Fundacion Ecuador can help facilitate this process. Expertise can be drawn from individuals with experience in establishing markets in developing countries and from organizations that have experience with "upstairs" trading systems such as NASD, the Midwest Stock Exchange, the Vancouver Stock Exchange or similar organizations. Steps to be taken include:

- analysis of legal (e.g., registry and title transfer) and market requirements for the development of a computerized market;
- development of organizational structure and business plans, including cost projections;
- design of technical specifications;
- analysis of technological systems alternatives and costs;
- assistance in installation and training.

markets. The objective is to learn the lessons that can be drawn from the successes and failures of other emerging markets with similar circumstances and constraints. Final topics will be selected by the CMDC, the Fundacion Ecuador and the securities exchanges and could include:

1. Pension System Reform and Capital Market Development

- speakers from Chile to discuss ADC experience, i.e.,

  - how reforms were implemented;
  - what were the obstacles found, and how overcome;
  - what is the necessary legal and regulatory apparatus;
  - what are the mechanics; how structured;
  - public relations; how did they build popular support;
  - etc.

2. Regulatory Framework

Once the Securities Market Law is passed, a one-day seminar on the key, immediate next steps should be convened. Speakers should include those with U.S. regulatory experience, and those with emerging markets experience.

3. Over-the-Counter Trading

A one-day roundtable of some of the country's leading bankers, brokers and representatives of the exchanges should be held to develop consensus, and discuss measures that would open up and develop an integrated national market.

C. Implementation Support

In order to facilitate implementation of highly technical initiatives, outside specialists will be contracted to provide support in two key areas that will be critical during the early stages of capital market development. Approximately 140 person-days of assistance will be needed in each area:

1. Assist in the development of the CNV, and self-regulatory functions of the securities exchanges/SROs.

Regulatory experts with NASD/SEC experience can work with the CNV, the securities exchanges and other SROs to:

- develop SRO rules and a consensus for the SRO method of operation;

- develop CNV division functions; develop a one-year and a five-year plan for each division; assist in the rule writing process;

- develop a comprehensive surveillance and enforcement program, including the CNV, exchanges and SROs;

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Attachment B.

Organization of Capital Market Development Committee

A key recommendation of the Price Waterhouse Ecuador Capital Markets Development Report is that an Ecuadorian leadership committee or working group be established to:

- involve all categories of Ecuadorian market participants in the development of the capital market;
- involve the private sector and government in a continuing dialogue;
- facilitate unification of a fragmented market;
- identify issues, conduct/direct analyses, contract research and studies, disseminate information;
- provide leadership and continuity, and
- focus actions and lobby for market development.

The importance of such a committee for accomplishing capital market development objectives has been confirmed through direct consultations with representatives of both exchanges and of the Fundacion Ecuador. Following are specific proposals on the composition of the proposed Capital Market Development Committee (CMDC), and suggestions on its organization and functioning.

First, having discussed the pros and cons of direct governmental involvement in the CMDC, it is here recommended that this body be fully representative of all segments of the private sector that have a direct interest in capital market development, but that it not include government representatives in its permanent membership. This is to facilitate the development of a private sector consensus on key market development issues, which would serve as the basis for a unified private sector position to be presented to government, which may or may not be at all times consistent with the political orientation of the government in power. The CMDC should maintain permanent liaison with key government agencies, including specifically the Junta Monetaria, Ministry of Finance and the National Congress, but should be free to develop its positions, and to act, independently of political considerations.

Proposed membership/representation in the CMDC is as follows:

- Bolsa de Valores de Quito
- Bolsa de Valores de Guayaquil
- Asociacion de Agentes de Bolsa de Quito
- Asociacion de Agentes de Bolsa de Guayaquil

- Asociacion de Bancos Privados
- Asociacion de Financieras
- Asociacion de Intermediarias Financieras
- Camara de Industrias de Pichincha
- Camara de Industrias de Guayaquil
- Federacion de Camaras

The Chairman (Presidente) of the CMDC should be a person of the highest standing within the financial community, with a strong personal commitment to capital market development.

The CMDC should, in addition, recruit a distinguished professional to serve as Executive Secretary, and to chair an Executive Committee, consisting of the Executive Secretary and four other representatives of CMDC member organizations, elected to serve on a rotating basis. The position of Executive Secretary should be a paid, full-time position, supported by an Administrative Assistant and adequate office and logistical facilities. The costs of maintaining the Executive Secretariat should be financed through contributions paid in by each of the CMDC member organizations, with possible partial and time-limited initial support from USAID or the Fundacion Ecuador. To the extent possible, operations of the Secretariat should by funded by CMDC members themselves, on an equal assessment basis.

The formation of the proposed Capital Market Development Committee will take several months. In the meantime, therefore, it is proposed that the Fundacion Ecuador organize an *ad hoc* Interim Committee to spearhead the process and provide a suitable counterpart to the Capital Market Development Advisory Team during the early part of 1993, when approval of a new Securities Market Law and other important governmental initiatives are expected to take place. The Interim Committee will naturally evolve, after a period of 6 to 12 months, into the proposed "permanent" CMDC.

Fundacion Ecuador may assist in the organization of the Capital Market Development Committee by contacting each of the proposed member organizations to discuss the concept, and secure necessary commitments, as well as in providing initial support in the recruitment of a suitably-qualified Executive Secretary.

The Interim Committee, then the CMDC, will become the principal counterpart of the Capital Markets Development Advisory and Technical Assistance Team, providing essential leadership, guidance and commitment to implementation, to ensure the most effective utilization of outside technical assistance resources.

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